30/09/2015

European Banking Association

EBA discussion paper and call for evidence on SMEs and SME supporting factor (EBA in EBA/DP/2015/02)

The Swedish Bankers' Association welcomes the opportunity to comment on the discussion paper. The discussion paper ambitiously seeks to assess if the SME supporting factor has supported SME lending and we note that the EBA present valuable information on overall SME performance and lending trends. This despite the difficulty to isolate the effect of the SME supporting factor on SME lending due to the wide range of regulatory adjustments introduced, monetary policy actions taken and the uncertain macroeconomic environment experienced during the studied time period.

The Swedish bankers' Association agrees with the EBA's assessment that any EU-wide SME risk analysis is subject to substantial obstacles that in part can be attributed to different SME definitions across member states. An obvious mitigating action would be a more harmonised definition of SMEs which would increase comparability across banks and jurisdictions and support supervisors. This in turn could contribute to more aligned supervisory practices across European competent authorities and support a standardised European supervisory framework.

It is the view of the Swedish Bankers' Association that the SME supporting factor has supported lending and contributed to European recovery, despite the uncertainties affiliated with European recovery which can be expected to have reduced the demand for credit. The experienced support stems the fact that lower capital requirements reduces the cost of lending and the interest rate faced by borrowers which in turn increases demand among the customers which has passed the hurdle of credit quality assessment. In addition, the supporting factor has supported operations by releasing otherwise locked resources, which has had a positive effect on overall credit supply. However, it is important to note that the design of the SME supporting factor makes pricing difficult. The reason for this is that the SME support factor regulation is temporary and that the design of the SME factor results in cliff effects. Thus, the discount is not always considered fully in the pricing decision which hampers credit growth to SMEs.

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It should also be noted that banks' credit quality assessments do not change in response to lower capital requirements. Borrowers' debt servicing ability is unrelated to regulatory capital requirements and the Swedish Bankers' Association would like to stress that our members' assessment of creditworthiness is conducted using the same set of tools as before with the same requirements.

Specific EBA questions

Q1: Do you have systems in place to track the reduction in capital due to the application of the SME Supporting Factor (capital relief)? Yes/No. Please explain and provide evidence.

Yes. Swedish banks have created systems to track the reduction in capital due to the application of the SME Supporting factor. For some banks, stipulated requisites for application of the supporting factor are implemented in the capital adequacy compilation routines and exposures relevant for the preferential treatment are flagged. At a later stage, the SME supporting factor is applied. Thus; relevant exposures can be singled out and the different outcomes of the calculations, whether applying the SME supporting factor or not, can be compared.

Q2: In your experience, is the reduction in capital requirements due to the application of the SME Supporting Factor (capital relief) being used to support lending to SMEs? Yes/No. Please explain and provide evidence.

Yes. It is the Swedish Bankers' Association's experience that the SME supporting factor has supported lending and contributed to European recovery, despite the uncertainties affiliated with European recovery which is expected to reduce the demand for credit. The lower capital requirements reduces the cost of lending and the interest rate faced by borrowers which in turn increases demand among the customers which has passed the hurdle of credit quality assessment.

In addition, the supporting factor has supported operations by releasing otherwise locked resources, which has had a positive effect on credit supply.

Two features of the SME supporting factor have, however, made full use of it challenging. Firstly, the design of the SME factor results in cliff effects since if a customer breaches the exposure or turnover cap, banks will experience an increase in capital requirements due to the removal of the SME supporting factor. Secondly, the SME supporting factor regulation is temporary creating regulatory uncertainty. Taken together, the cliff effects imposed in combination with regulatory uncertainty has had the consequence that the potential discount for firms eligible for the supporting factor is not always considered to its full extent.

Q3: Is your internal definition of SMEs in line with the definition of SME exposures subject to the SME Supporting Factor? Yes/No. If no, how are you reconciling the internal definition of SMEs with the definition of SMEs subject to Supporting Factor? Please explain and provide specific examples.

This differs from member to member but for some banks, the internal definition of SMEs is somewhat wider than the definition of SME exposures subject to the SME supporting factor since counterparties are identified in accordance with current reporting requirements.

Q4: In monitoring the total amount owed to you, your parent and subsidiary undertakings, including exposures in default, by the borrower and its group of connected clients (as defined in CRR Article 4(1)(39)), what reasonable steps do you take to ensure that amount does not exceed EUR 1.5 million in accordance with Article 501(2)(c

In accordance with current reporting requirements, some members identify counterparties in order to fulfil the EC recommendation 2003/361/EC of 6 May 2003 on definition of micro, small and medium-sized enterprises (SME) as well as how to view an enterprise's ownership connections with other enterprises. After identification in accordance with current reporting requirements, some members use the criteria set out in Article 501 of the CRR to filter out the subset of SMEs subject to the supporting factor.

The thresholds are built into the IT solution and the monitoring process is automated.

Q5: Do you see merits in having a harmonised definition of SMEs for reporting purposes? Yes/No. Please explain and provide specific examples.

A more harmonised definition of SMEs for reporting purposes would be welcomed since it would increase comparability across banks and jurisdictions and support supervisors. This in turn could contribute to more aligned supervisory practices across European competent authorities. Also it would facilitate internal reporting processes and practises at banks.

Q6: Do you agree with the proposed measures of SME riskiness? Yes/No. Are some of these measures more relevant than others? Yes/No.

By and large, the Swedish Banker's Association agrees with the proposed measures of SME riskiness. However, it is important to note that the interpretation of the proposed risk measure should differ across industries since e.g. the measure of activity (turnover/assets) is naturally low in commercial real estate (CRE) compared to retail. Thus, variations in the aggregate measures may only reflect changes in a dominant or particular large sector and not variations for a representative SME due to the heterogeneity across sectors. Also the stage in the business cycle the SME is in as well as ownership and management characteristics should be accounted for.

In addition, the proposed risk drivers do not have equal weight with regards to their contribution to default probability. Thus, the composite index as depicted in Figure 8 in the discussion paper (EBA/DP/2015/02) is in part misleading and the conveyed message that SMEs in general had a larger decrease in credit quality than larger firms is in the Swedish Bankers' Associations' experience largely dependent on regional characteristics and market maturity. The following factors are seen as particularly important in evaluating the SME riskiness and should hence be given a greater weight in a composite index if such is to be used; capital structure, return on assets and interest coverage.

Examining the EBA proposed measures of riskiness, as discussed in section 4.2 in the discussion paper, the Swedish Bankers' Association agrees with the conclusion that SMEs show a better profile than larger firms for the two risk indicators leverage and liquidity and that larger firms outperform SMEs with regards to profitability, activity and coverage. This is in line with our members' experience; that SME lending relative lending to large corporates is more risky when it comes to the default probability of the individual counterparty, but that the nature of the SME credit risk is idiosyncratic. However, larger firms compared to SMEs had a larger percentage drop from peek to bottom in default driving aggregate indicators such as coverage and profitability during the global financial crisis. This finding is well aligned with both theoretical and empirical studies that conclude that larger firms are more affected by global systemic risk factors since asset correlations increase with the size of the firm. As discussed by the EBA in the discussion paper (pp. 28), lower asset correlations for smaller firms should translate into a lower capital requirement which in turn emphasises the appropriateness of the SME supporting factor.

Q7: Are other aspects relevant in your assessment of the creditworthiness/riskiness of potential SME borrowers? Yes/No. If yes, please provide a list of those aspects and explain how you measure SME riskiness.

Swedish banks include a wide range of detailed balance sheet information in their risk assessment processes. In addition, they use a wide range of supervisory approved internal models and econometric models that gives the banks insights and experience which feeds back into the banks' initial assessment of borrowers' creditworthiness.

The following factors are seen as particularly important in evaluating the SME riskiness; capital structure, return on assets and interest coverage. In additional qualitative factors covering ownership and management risk in particular are accounted for. The ability of owners and management is a deciding factor for the SMEs ability to attract new capital in challenging times.

Q8: In your experience, are SMEs as cyclical or more/less cyclical than large enterprises?

It is our members' experience that large enterprises are more affected by cyclical global systemic risk factors than SMEs. SMEs tend to be more affected by local/regional downturns than larger enterprises. In part, such local/regional downturns can be described as a contributor to idiosyncratic risk which has a greater impact on SME lending than systemic risk events.

The cyclicality of SMEs does, however, vary with the sector. In general, more luxury oriented companies like restaurants are more cyclical than other industries. Also construction companies are cyclical as demand can change rapidly while the possibility to adjust capacity at the same rate is limited. Lawyers and auditors tend, on the other hand, to be less cyclical.

Q9: Do you agree with the proposed methodology to assess the own funds requirements in relation to SME riskiness? Yes/No. If no, please provide alternative methodologies or indicators, if available.

The Basel formula for calculating risk weights is highly dependent on the single risk factor which is to be interpreted as the systemic component of credit risk. Thus, if asset correlations are lower for SMEs, the own funds requirement should be lower.

There is room for improvement as to the presentation of the methodology in order to make it easier to appropriately assess.

Q10: Did the arrears and loss experience in 2009/2010/2011 exceed an (internal) limit? Yes/No. Were (expected/unexpected) losses adequately covered by loan loss provisions? Yes/No. Please explain and provide specific figures.

During 2009-2011, the performance of loans largely depended on the severity of the economic downturn in regional markets. In Sweden, losses were well below expected loss estimates while the opposite at times occurred for specific borrowing segments in other markets. Arguably, the performance of exposures in other non-Swedish markets during the crisis can in part be explained by the severity of local downturns as well as the countries' level of economic maturity. Possibly, the systemic/cyclical component in SME credit risk is dependent on economic development and market maturity. Thus, it is possible that SMEs operating in more mature markets are less prone to suffer from cyclical global systemic risk factors. In addition, the private sector structure affects the vulnerability of SMEs. For example, it matters whether the SMEs are largely made up of suppliers to a local large industry (e.g. off shore suppliers in Norway or automaker suppliers in Germany) or if they are themselves "independent" actors on the global market (e.g. software developers).

Q11: Do you agree with the above interpretation of statistical data on lending trends and conditions? Yes/No. If no, please explain.

No answer.

Q12: Since 1 January 2014, have you changed your SME credit lending and assessment policies and procedures, specifically as a result of the introduction of the Supporting Factor? Yes/No. If yes, please explain and provide specific examples.

Borrowers' debt servicing ability is unrelated to regulatory capital requirements and no change in lending standards has occurred due to the introduction of the supporting factor. The supporting factor for SMEs is unrelated to prudent credit risk assessment practices and even though capital requirements may be lowered, our members' assessment of creditworthiness is conducted using the same set of tools as before with the same requirements.

Even though our members' SME credit lending and assessment policies and procedures remain unchanged, it is important to note that the SME supporting factor has supported lending to SMEs. This since lower capital requirements reduces costs which translate into lower interest rates faced by borrowers and an increase in credit demanded by firms that meet the requirements set out by the banks. In addition, the supporting factor has supported operations by releasing otherwise locked resources, which has had a positive effect on credit supply.

Q13: Have changes to your SME credit lending and assessment policies and procedures been driven by other factors (e.g. competition from alternative sources of SME financing as described in section 4.1)? Yes/No. Please explain and provide specific examples.

Yes. The uncertain macroeconomic environment in combination with exceptionally low interest rates has increased the Swedish banks' focus on a prudent application processes.

Q14: In your experience, is there an impact of the SME supporting factor on the volume of SME lending compared to other loans? Yes/No. Please explain and provide evidence.

Yes. In our members' experience, the SME Supporting Factor has supported lending to SMEs. This since lower capital requirements reduce costs which translate into lower interest rates faced by borrowers and an increase in credit demanded by firms that meet the requirements set out by the banks.

In addition, the supporting factor has supported operations by releasing otherwise locked resources, which has had a positive effect on credit supply.

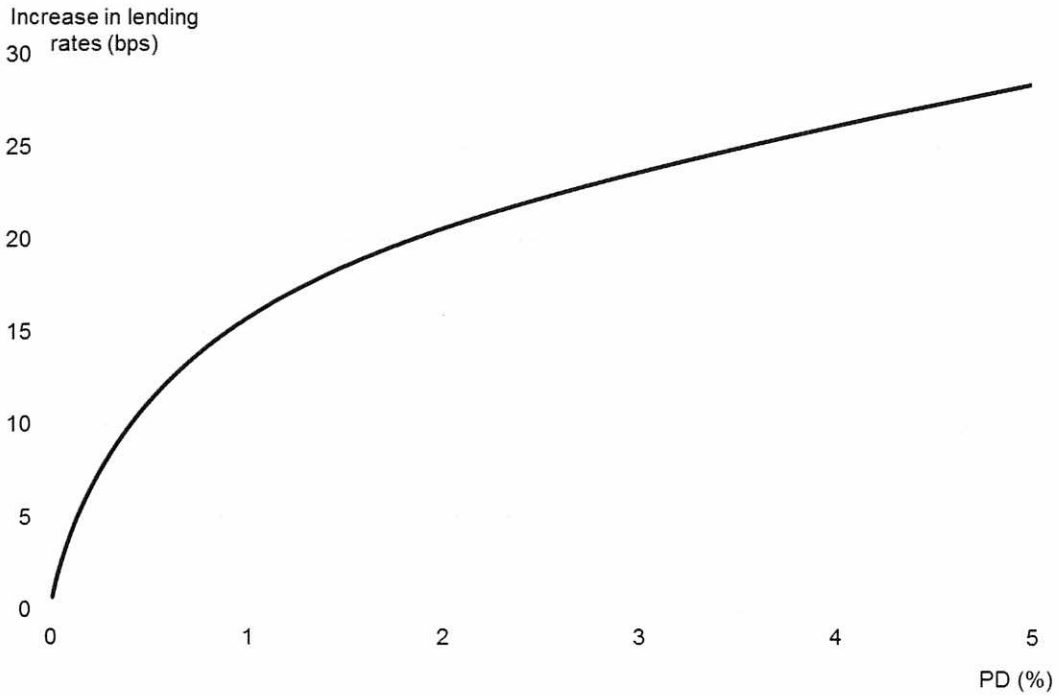
It is challenging to single out the effect of the SME supporting factor on lending volumes and conditions as other regulatory initiatives were implemented simultaneously. Also other aspects such as economic condition across EU countries impact SME lending, and the introduction of the SME factor coincided with generally much higher capital requirements. Thus a before and after comparison with the SME supporting factor implementation as cut-off point is not really possible to make. Therefore, we warmly welcome the formal empirical study of the credit supply effects to be presented by the EBA in an updated version of the discussion paper. In interpreting the results thereof, it is crucial to acknowledge that fully disentangling the impact of the SME supporting factor from everything else affecting SME lending is very challenging.

Empirical academic studies indicate that the semi-price elasticity for credit in Europe differs substantially between countries and regions, varying from -0.01 to -10.81. To illustrate the potential effect of the SME supporting factor, we use an estimate of semi-price elasticity of -1.1. Assuming a decrease in lending rates by 25 bps due to the introduction of the supporting factor, the supporting factor can be expected to have increased SME credit demand by at least 0.28 percent. This result is highly dependent on the assumed semi-elasticity. Using the lower end of the empirically investigated elasticities (ceteris paribus), it is found that SMEs subject to the supporting factor credit demand could have increased by as much as 2.7 percent in some European countries. The actual realisation of this volume change does naturally depend on whether there actually is demand for the increased supply of SME loans.

Q15: In your experience, is there an impact of the SME supporting factor on the pricing and overall conditions of SME lending compared to other loans? Yes/No. Please explain and provide evidence.

Since capital is costly, lower capital requirements leads to lower required margins. In practice, this translates into lower lending rates for borrowers. The effect of the supporting factor on lending rates is illustrated for an example bank subject to a fixed return target. For a set of fairly realistic assumptions, it is estimated that the removal of the supporting factor will increase lending rates to firms currently subject to the supporting factor by between 6.5 and 25 bps, dependent on the characteristics of the borrower. Notably, this effect is larger when market returns are low and increases with the riskiness of the firm as depicted in Figure 1 below.

Figure 1: Effect of the removal of the supporting factor on lending rates given a set of realistic assumptions for an example bank subject to a fixed return target.



Note: The example illustrates the effect for an A-IRB bank that has granted a one year loan to an SME with an estimated LGD of 30 percent. The example abstracts from possible tax effects.

In this context, it is important to emphasize that the effect illustrated here is based on an "all else equal" reasoning for a broad portfolio of SME:s. The effects could be much more pronounced in some segments of the SME sector. The effect presented is also the one that comes from the pricing mechanism. The effect for banks that have had a capital constraint, and therefore have been forced to credit rationing, may have been much more dramatic, since lending capacity in those cases will be released when the SME factor lower the overall capital requirement.

Q16: Do you consider SMEs are a consistent group when it comes to access to credit or should a distinction be made between different types of SMEs (e.g. micro, small and medium ones)? Yes/No. Please explain and provide specific examples.

SMEs are not a consistent group. In our members' experience, larger SMEs are more dependent on global macroeconomic conditions while smaller SMEs are more dependent on local/regional economic conditions. In addition, heterogeneity also arises across different sectors since they may be affected by various risk drivers. From a regulatory perspective, it is hard to make any differences between SME:s, apart from the ones already in place based on size, since the circumstances may be very different in different jurisdictions.

SWEDISH BANKERS' ASSOCIATION

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